Slowing credit growth, margin pressure may weigh on banks

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In 2025 banks are in for challenges such as pressure on margins and slowing credit growth.

With the likelihood of a repo rate cut in February or April, external benchmark-linked loans of banks will be repriced immediately.

However, deposit rates are expected to adjust more gradually, which could impact the net interest margin (NIM) — a key measure of profitability for banks. According to experts, private banks could be impacted more owing to this because they have a larger share of external benchmark-linked loans.

"An interest rate cut could give banks some breathing room, especially in terms of reducing funding costs, and deposit rates may not fall proportionally, meaning raising deposits could remain costly, which would put continued pressure on the NIM," said Dolphy Jose, executive director, South Indian Bank.

Resource mobilisation was a key challenge for banks for the last two years, because deposit growth lagged a credit uptick. In the last month, however, with credit growth slowing significantly, the gap has closed. According to Saurabh Bhalerao, associate director, Care Edge, reduction in the spread between the lending and deposit rates on account of a rate cut, competition, and banks having a larger share of term deposits in higher interest rate buckets are likely to put pressure on banks' margins, particularly for private banks, which have a high proportion of loans linked to external benchmarks.

THE YEAR AHEAD

- With a rate cut being imminent in 2025, banks are likely to face pressure on net interest margins
- Credit growth, which has come off highs in 2024, may not see major revival
- However, corporate credit growth may see an uptick
- With strong balance sheets, banks will be able to absorb the hit from various regulatory challenges
- Asset quality is expected to remain benign; however, some pockets will stress build up

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The banking sector faces a range of regulatory challenges, including new norms on project finance, expected credit loss (ECL), the liquidity coverage ratio, and subsidiary regulations.

While experts say banks will be able to absorb the impact of the regulatory shifts, given they are in the pink of health, with strong balance sheets. According to Jose, banks could see a dip in return on assets, potentially leading to increased lending rates and stricter credit criteria. "Project financing, in particular, might see banks becoming more selective. Public-sector banks could face greater challenges than their private counterparts."

The Reserve Bank of India's (RBI's) draft norms on project finance require banks to set aside 5 per cent as provisions for loans for under-construction infrastructure and real estate projects.

Meanwhile, the proposed liquidity coverage norms are likely to impose more run-off factor of 5 per cent on both stable and less stable retail deposits that are enabled with internet and mobile-banking facilities. As far as the proposed ECL norms are concerned, the RBI has proposed that banks will have to recognise stress much earlier, in contrast to the current regime in which they make provisions after the losses have been incurred.

"...the sector remains in robust health, with banks' balance sheets stronger than ever. This positions them well to absorb the impact of the anticipated regulatory shifts," said Anil Gupta, vice-president, financial-sector ratings, ICRA.

The RBI's decision to increase risk weightings on bank lending to non-banking financial companies and unsecured loans has led to a decline in credit growth to these key segments. The industrial segment is likely to continue improving, with gross non-performing assets (NPAs) falling below 3 per cent from a peak of over 20 per cent in 2018. However, retail NPAs may slightly rise, primarily due to unsecured loans, but are likely to remain range-bound, said Aniket Dani, director, research, CRISIL Market Intelligence and Analytics.